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# Stock ownership plans for employees

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**STOCK OWNERSHIP PLANS FOR EMPLOYEES**

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**A THESIS  
PRESENTED TO  
THE FACULTY OF THE SCHOOL OF BUSINESS ADMINISTRATION**

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**IN PARTIAL FULFILLMENT  
OF THE REQUIREMENTS FOR THE DEGREE  
MASTER OF SCIENCE IN BUSINESS ADMINISTRATION**

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**BY  
E. ELWOOD FORD**

## CHAPTER I

### HISTORY OF STOCK PURCHASE PLANS AND STOCK OPTIONS

The purpose of this paper is to present a reasonably adequate presentation of some of the developments in Stock Ownership Plans for Employees.

Plans for employee stock ownership have developed into two categories, one more often relating to employees in general and the other more often relating to a restricted number of employees, usually executive.

Stock Purchase Plans. These plans are usually designed for employees in general, although some specifically exclude executive employees. Such plans are designed primarily to give more and more employees a direct ownership in the companies by whom they are employed. Perhaps the major problem that arises is the failure or inability of so many employees to fully comprehend the position of a holder of common stock. Another problem in these plans relates to the fact that, even if employees were fully aware of the position of a holder of common stock, not all employees are in a position to take the risks that go with it, especially in the corporation upon which they depend for their salaries or wages.

Stock Option Plans. These plans are usually designed for a relatively few high-level employees and are motivated almost exclusively by reason of Federal income tax considerations. Among this group of employees there is a much better comprehension of the position of a common stockholder and more of them are in a position to take the related risks. The major problems in these cases are (1) the ever-changing income tax laws affecting the taxability of profits that may result from the options and (2) the effects on other stockholders, particularly the minority stockholders.

Because the problems that relate to employee stock ownership plans are substantially different in the plans designed for employees in general as against those designed for certain executive employees, the two types of plans will be discussed separately after a review of Stock Ownership Plans for Employees in general.

For many years stockholders, business executives, and employees have followed with interest various plans designed by certain corporations to permit, encourage, or assist employees to purchase capital stock in the companies by whom they are employed.

On December 17, 1956, Mr. Keith Funsten, President of the New York Stock Exchange, said, "The Employee Stock Ownership Plans of many large companies are proving highly effective in giving more and more Americans a direct ownership interest in our business system—bringing us nearer to a true democracy."<sup>1</sup>

The popularity of Stock Ownership Plans has been and is still apparent from the fact that approximately forty per cent of all domestic companies having common stock listed on the New York Stock Exchange adopted stock purchase or stock option plans within the nine-year period from 1947 to 1957. There were additional plans started prior to 1947, and many have been put into effect since 1957. Such plans are not in any sense restricted to companies listed on the New York Stock Exchange but rather cover corporations of all sizes and types.

Some of these plans have been eminently successful in the attainment of their goals while others have been most unsuccessful. This wide variation

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<sup>1</sup> Stock Ownership Plans for Employees, New York Stock Exchange, December 1, 1956, p. 1.

in the degrees of success or failure has resulted in certain deep-seated anxieties as to the consequences of the use of this method of cultivating the employee's loyalty to his own company and confidence in the private enterprise system generally.

Most of the plans relate to common stock and it is this fact that contributes largely to the anxieties. No way has yet been found by which employees, or anyone else, can enjoy the benefits of common stock ownership without being subject to the related risks. In consideration of the risks they assume, the owners of common stock are claimants against all the corporate profits that remain after income taxes and responsibilities to preferred stockholders have been met. To the extent, therefore, that common stockholders receive dividends that fall short of these profits, they make, on a more or less permanent basis, further contributions to corporate assets. There are many investors whose savings are such that they should not invest in securities that have the lowest claim on profits, particularly when it is very probable that a substantial portion of the remaining profits will be permanently retained by the corporation. This partial retention of profits combines with the absence of a maturity date to make the common stockholder largely dependent on the "market" as a means of recovery of his investment. Thus, market fluctuations come to assume too great a basis of gain or loss.

There is a related question. If an employee is "investing" his life's efforts as an employee of a given corporation, might it not be better for him, in order to spread his risk, to invest his savings in another corporation. It is difficult to determine whether this point is more relevant when the employee's savings are little in amount and his duties as an employee have no part in management and policy decisions or when his savings amount to a substantial sum and his duties as an employee do have a part in management

and policy decisions.

In the process of the development of these plans, since no one of the plans is exactly like another, the more recent plans have brought with them many new features. These new features usually have been designed in an effort to improve the chances of the attainment of the ultimate goals or to overcome certain impressive potential objections by the stockholders or a part thereof.

The continued success of the many employee stock ownership plans has resulted in part from continued favorable economic conditions and changes in the provisions of the Federal income tax laws. It is interesting to note that The Revenue Act of 1964 has materially restricted the income tax benefits of many stock option plans.

While the list of companies that have adopted stock ownership plans is very impressive, it must be said that the list of companies that have not adopted any such plan is also impressive.

## CHAPTER II

### STOCK PURCHASE PLANS

Stock purchase plans are plans by which companies permit, encourage, or facilitate the acquisition of stock by employees. In making it possible for an employee to acquire a substantial stock interest, a stock purchase plan serves an objective long sought by many shareholders--giving management and other employees an identity with stockholders. In some corporations, stock purchase plans may eventually result in replacing "hired-hand" management with stockholder management.

Employees Eligible to Participate. Some plans are designed for large numbers of employees; some include officers and key employees; still others specifically exclude officers and key employees.

The Employees' Stock Plan of American Telephone and Telegraph Company provides for participation by "any regular employee . . . except officers . . . ."2

The Employees' Stock Purchase Plan of Chesapeake and Ohio Railway Company provides for participation by "any employee of the Company . . . except (a) directors (b) officers (c) persons included in the Stock Option Incentive Plan."3

The Employees' Stock Purchase Plan of Commonwealth Edison Company, however, provides that "All regular employees of the Edison Company, regardless of their position or rate of pay . . . may participate in the Plan as long as they are regularly employed."4

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<sup>2</sup> Prospectus of American Telephone and Telegraph Company, October 21, 1954.

<sup>3</sup> Prospectus of the Chesapeake and Ohio Railway Company, April 28, 1955.

<sup>4</sup> Prospectus of Commonwealth Edison Company, June 17, 1955.

Assistance or Contribution by Company. In some plans the companies do little more than act as agent or broker for the employee, purchasing stock for him in the market and at market price. Some companies take a further step and advance loans to the employee to enable him to make the purchase. Still a further step takes place when the company offers the stock to employees at some price below the current market price. In some cases the plan may provide for a contribution of company funds to employee purchases, in effect the equivalent of an increase in his compensation.

American Telephone and Telegraph Company sets a price on the stock as follows: "The purchase price per share . . . will be \$20.00 below the average market price either for the month in which payment is completed or for the next succeeding month, whichever is lower. . . ."<sup>5</sup>

Bridgeport Brass Company provides for purchases at prevailing market prices. The company supports its plan by explaining that there will be substantial savings under its plan by the elimination of brokerage costs.<sup>6</sup>

The Commonwealth Edison Company plan provides that the price per share will be ninety per cent of the closing market price but not less than \$25.00 per share.<sup>7</sup>

General Foods Corporation provides that for each five shares purchased under its plan for the account of an employee-participant, the corporation will deliver to him, without cost, an additional share.<sup>8</sup>

Source of Stock. In the majority of cases previously authorized but unissued stock is used for both stock purchase and stock option plans. In some cases, however, the stock is purchased on the open market.

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<sup>5</sup> Prospectus of American Telephone and Telegraph Company, October 21, 1951.

<sup>6</sup> Prospectus of Bridgeport Brass Company, September 1, 1952.

<sup>7</sup> Prospectus of Commonwealth Edison Company, June 17, 1955.

<sup>8</sup> General Foods Corporation Employees Savings Investment Plan, November, 1955.



American Telephone and Telegraph Company set aside 3,000,000 shares of its authorized but unissued stock for its plan. The Chesapeake and Ohio Railway Company reserved 300,000 shares of common stock for its plan out of authorized but unissued stock.

Difficulties. The encouragement of ownership of a company's stock by employees is a matter of general interest to business executives and one over which there is great diversity of opinion. On the one hand there is general belief that conflicts between economic classes can be reduced by a more widespread diffusion of securities among employees. On the other hand there are very deep-seated fears as to the consequences of the use of this method of cultivating the employee's loyalty to his own company and his faith in the private enterprise economy. These fears arise from the fact that no way has yet been found by which employees, or anyone else, can enjoy the benefits of common stock with their risks. When they own stocks which fluctuate seriously in value, and in particular when they sustain losses which are heavy in proportion to their means, then stock ownership by employees is likely to have the reverse effect from that which was intended. Instead of more confidence in the company, there is less confidence; and instead of loyalty, there is likely to be disappointment and antagonism. For these reasons many businessmen hesitate to embark upon such plans. They refer to some well-known plans of the 1920's and early 1930's in which very heavy losses were sustained by employee stockholders. The memory of these still lingers, and one vice-president, referring to them, remarked, "We never had an employee stock purchase plan, thank God."<sup>9</sup>

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<sup>9</sup> Thomas H. Sanders, Effects of Taxation on Executives (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1951), p. 121.

Since stock prices have risen impressively since 1950, the plans started since 1950, for the most part, have proven very successful for the participants. In most cases it would seem that stock purchase plans are more suitable for old, well-established companies in well-known industries.<sup>10</sup>

In any case it would seem that any plans to offer the company's stock to its employees should be undertaken only with great care and with the frankest explanation to the employees of the kinds of risk they are undertaking and the possible consequences. Even registration statements filed with the Securities and Exchange Commission do not fully cover all of the problems involved. Their formal style and technical statements make little or no impression upon people not trained to understand them. If a plan cannot be presented to employees in plain and simple terms, which will at the same time inform them of the risks involved, and yet be sufficiently attractive to induce them to buy the company's stock, then the company's management had better leave the problem of interesting workers in the private enterprise system to other devices.<sup>11</sup>

Efforts to Overcome Difficulties. The following excerpts from certain company announcements of employee stock ownership plans illustrate efforts to avoid some of the difficulties heretofore mentioned.

Bridgeport Brass Company. "No promotion of this plan has been undertaken because the Directors feel that any employee wishing to become a stockholder should know that such a plan is available to him, but should not feel any urge from management to take up the plan."<sup>12</sup>

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<sup>10</sup> Sanders, loc. cit.

<sup>11</sup> Sanders, op. cit., p. 123.

<sup>12</sup> Prospectus of Bridgeport Brass, September 1, 1952.

The Cincinnati Gas and Electric Company. "In the belief that the investment in equity securities by employees would tend to acquaint them with some of the problems confronting business in general, and their company in particular, and that the ownership of such shares would create in them a greater sense of responsibility toward the successful operation of their company, as well as broaden their concept of the American free enterprise system."<sup>13</sup>

Commonwealth Edison Company. "First, we are not trying to induce you to buy Edison stock. If you wish to participate in the Plan, we will be glad to have you do so. But your standing will not be affected in any way by your decision. No one is authorized to urge you to participate.

"Second, when you are making up your mind whether or not to buy Edison shares, you must remember that the prices of common stock, including Edison stock, go up and down. At times the decline may be drastic.

"Third, once you have purchased Edison shares, they will be yours. The company will not buy them back from you at any time.

"Fourth, we recognize, and you should not hesitate to face the fact, that not all employees are in a position to take the risk that goes with the ownership of common stock."<sup>14</sup>

General Foods Corporation. "Although we believe this plan to be a sound one, we caution each employee to give careful consideration to his own overall financial situation and to the nature of the program. In our literature we cite the element of risk in common stock."<sup>15</sup>

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<sup>13</sup> Prospectus of The Cincinnati Gas and Electric Company, March 15, 1950.

<sup>14</sup> Prospectus of Commonwealth Edison, June 17, 1955.

<sup>15</sup> Prospectus of General Foods Corporation, November 28, 1955.

General Motors Corporation. "No one will urge them to take part in this program. The decision to do so will be entirely their own."<sup>16</sup>

Inland Steel Company. "Our program is voluntary. No employee need participate. In fact, great care is taken to explain that the purchase of common stock is a risk which might result in losses as well as profits."<sup>17</sup>

The success of many employee stock ownership plans depend largely on the success of the company involved. Many such plans started in the 1920's were abandoned in the early 1930's. Some, however, survived. An outstanding example of a surviving plan is that established by Sears, Roebuck and Company on July 1, 1916. As of December 31, 1955, there were 125,299 participating employee-members. The company's contribution for 1955 (computed at ten per cent of consolidated net income) was \$40,362,020 and employees owned 18,805,506 shares or 25.4 per cent of the company's capital stock.

The Sears, Roebuck and Company plan is a Savings and Profit-sharing Fund, control over which is legally and financially separate from company management. The sources of capital for the fund are (1) the deposits of employee members, and (2) the annual contribution by the company. With these funds, shares of Sears, Roebuck and Company common stock are purchased.

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<sup>16</sup> Prospectus of General Motors Corporation, November, 1955.

<sup>17</sup> Prospectus of Inland Steel Company, July 13, 1955.

## CHAPTER IV

### SUMMARY OF LISTING APPLICATIONS FILED BY COMPANIES

#### LISTED ON THE NEW YORK STOCK EXCHANGE, 1947-1955

The following information was taken from an analysis of arrangements for issue of stock to employees, officers, and directors as described in listing applications filed between 1949 and 1955 by companies listed on the New York Stock Exchange.

Of the eighteen listing applications filed in 1947, only eight plans represented stock purchase plans and ten represented stock option or compensation plans. Seven of the eight stock purchase plans covered all regular employees whereas all ten stock option or compensation plans were limited to executives or key employees. All eight of the stock purchase plans provided for installment purchases, some over periods as long as ten years.

Of the twelve listing applications in 1948, ten provided for stock purchase plans and only two for stock options. Seven plans covered officers and employees, two plans covered only selected executive employees, and one covered only key employees. In this year, three of the ten plans required full cash payment and seven had a provision for installment purchases.

The following schedule shows the increase in the popularity of stock ownership plans for employees and the breakdown of these plans as between stock purchase plans and stock option plans. This was prepared from listing applications filed with the New York Stock Exchange during the years shown.

<u>YEAR</u>	<u>TOTAL NUMBER OF NEW PLANS</u>	<u>NUMBER OF NEW STOCK PURCHASE PLANS</u>	<u>% OF CHANGE FROM 1949</u>	<u>NUMBER OF NEW STOCK OPTION PLANS</u>	<u>% OF CHANGE FROM 1949</u>
1949	22	18	-	4	-
1950	29	25	28.00	4	-
1951	74	15	-16.67	59	1375.00
1952	94	17	-5.55	77	1825.00
1953	77	22	22.22	55	1275.00
1954	77	21	16.67	56	1300.00
1955*	84	21	16.67	63	1475.00

\*(10 mos.)

Source: Stock Ownership Plans for Employees, New York Stock Exchange, December, 1956, pp. 118-206.

Generally, the majority of the stock purchase plans listed above cover all regular employees.

From the above it is obvious that while the number of stock plans for employees among the companies listed on the New York Stock Exchange increased from twenty-two in 1949 to a high of eighty-four in 1952, there was little increase in stock purchase plans covering employees in general. In 1949, there were only four stock option plans among companies listed on the New York Stock Exchange, but the number increased to fifty-nine in 1951 and a high of seventy-seven in 1952.

## CHAPTER V

### STOCK OPTION PLANS

Purposes. Stock options help a company create adequate executive incentives and rewards. Today's tax rates, living costs, and expenses incident to executive office render it difficult, if not impossible, for executives to accumulate an estate from savings out of current compensation. The stock option plan involves no corporate expenditure of funds and, in fact, brings more funds into the business. It provides a method for the smaller company, the growth company, the company with leverage stock, and the company unable to offer substantial cash rewards to compete for executive talent with large established businesses.

Employees Eligible to Participate. The great majority of stock option plans to cover only executives and key employees. General purchase plans open to all employees, such as those heretofore discussed, do not satisfy all the purposes involved in giving executives and key employees a substantial interest in their business, of a kind that is likely to serve as an effective incentive. In particular, the close connection between successful executive effort and profits cannot be expressed in the form of general stock purchase plans. For this purpose stock options are commonly regarded by companies as the suitable instrument, the one most attractive to executives.

Effect of Federal Income Tax Legislation. The substantial increase in stock option plans in recent years may be traced in large part to legislation first passed in 1950, conferring specific Federal income tax benefits on restricted stock options.

The legislation, in substance, provided that if a nontransferable stock option is granted to an employee, and if at the time of the grant the option price is at least ninety-five per cent of the market value of the stock covered by the option, no tax will be imposed when the option is exercised. The tax payable will be at capital gains rates on any profit if and when the stock is sold. However, the stock cannot be disposed of before two years from the time the option is granted. The law also required the holder to wait six months after exercising his option before selling the stock obtained.

Review of Federal Income Tax Status. The confusion over the taxability of stock options has a long history extending back to 1921, when Congress set up separate rate structures for ordinary income and capital gains. As long as income tax rates remained relatively low, this cleavage wasn't too important, and for years the Commissioner of Revenue held that the profit on employee stock options was extra compensation and taxable as ordinary income at the time the options were exercised and the stock acquired. In 1938, the Board of Tax Appeals (now the Tax Court) ruled that an option granted to an executive of Continental Can Company was a "proprietary" option and his profits when the option was exercised were not taxable as "compensation". The following year the Treasury Department decreed that all profits on proprietary options would be taxed, not on acquisition of the stock, but when the stock was sold, and then only at capital gain rates. The Treasury agreed to consider the evidence in each case and decide whether the option was proprietary or compensatory. Other executives subsequently defended their options as proprietary, but often the courts held them to be compensatory. The decisions hinged on a number of factors including the stated "intent" of the option, the length of time before it could be exercised, whether or not it was assignable, etc. But the factor that seemed most decisive was the degree



of spread between the option price and the market price at the time the option was granted. The narrower the spread, the more likely it was that the option would be held proprietary. The rule was not rigid; however, the spread in Geeseman's "proprietary" option was forty-five per cent.

The confusion over taxability of options was further compounded in 1945 when the Supreme Court held in the Smith case that the profit realized by John H. Smith when he exercised an option granted by his employer, the Western Cooperaage Company, was taxable as ordinary income, even though there had been no spread between the option price and the value of the stock when the option was granted. The court declared that the section of the revenue law that defines gross income "is broad enough to include in taxable income any economic or beneficial benefit conferred on the employee as compensation whatever the form or mode by which it is effected". On the strength of this, the Treasury ruled that options issued after the Supreme Court decision would be regarded as compensatory and the profits taxed as ordinary income when the options were exercised.

This ruling thoroughly dampened down enthusiasm of business executives for stock options, and between 1946 and 1950 very few plans were initiated. However, during those years lawyers, corporation executives, and spokesmen for the National Association of Manufacturers, the New York City Bar Association, and the New York State Society of Certified Public Accountants urged Congress to ease the treatment accorded options. The 1950 Revenue Act did so and provided the way for corporations to grant "restricted stock options" that would provide capital gains regardless of what the company's motives in granting the option might be.

Congress, however, attached a few restrictions. Among the conditions that must be met before an option can qualify are:

- (1) the option cannot be transferred.
- (2) the employee receiving the option cannot hold more than ten per cent of the company's voting stock.
- (3) the employee has to exercise his right to purchase while he is employed, or within three months after leaving the company.
- (4) the stock purchased cannot be sold for at least two years after the option is granted.
- (5) the stock has to be held for more than six months after the option is exercised.
- (6) the option price can be no lower than eighty-five per cent of the "fair market value" when the option was granted.
- (7) when the price was between eighty-five per cent and ninety-five per cent, the entire spread between the option price and the market value when the option is granted will be taxed as ordinary income, but only when the stock is sold.

Except for these restrictions, however, Congress implicitly let all other advantages of stock options stand. There was, for example, no limit on the number of shares that may be offered or on the number of option offerings, or on the number or earnings of employees who may participate. Thus, the 1950 Revenue Act left enormous latitude for variety among restricted option plans. In fact, no two option plans are alike. Some companies offer options to only one or two men; for example, President Frank Stanton of the Columbia Broadcasting System in 1954 held options to buy a total of 50,000 shares of his company's stock for \$1,703,000. Some option plans are extended to "key" executives; others include only officers. While most companies limit their option offers to unissued stock, the percentage of total option shares to outstanding stock prior to the option may range anywhere from 1 to 10 per cent or more. Bohn Aluminum and Brass Corporation, for example, offered over 11 per cent. In general, restricted stock-option plans have

tended to favor an option price of ninety-five per cent of market value, rather than the permissible eighty-five per cent. By limiting the option spread to five per cent, or by eliminating the spread entirely, a company can assure an executive that all his option profits will be treated as capital gains. Moreover, a small spread is less likely to annoy stockholders when they are asked to approve the plan.

Approval of option plans by stockholders has not stopped attacks on the legality of such plans. One of the few restricted-option cases decided against a corporation involved California Eastern Airways, Inc. In 1952 the Delaware Supreme Court declared the company's option plan invalid because it did not include a clause requiring the executive to remain with the company for a reasonable time, and thus in effect offered rewards to management with no guarantee of a return to the corporation. Since this decision, many companies have revised their option plans to include "employment clauses" that require participating executives to serve the company for at least one or two years.

Though the restricted stock option attracted a host of companies after 1950, some executives and lawyers thought such options still had several "weaknesses". One was the requirement that an executive hold his option stock for six months before he sold it, since even this minimum gamble could cost him a sizable sum if the market value of the stock happened to drop during the time he held the stock. This danger was amply illustrated in the case of the restricted stock option on 100,000 shares that Radio Corporation of America granted in 1950 to Chairman David Sarnoff. Sarnoff obtained \$1,775,000 in personal loans from banks and exercised his option in February, 1953, when R.C.A. stock was worth \$25.50, or \$7.75 above the option price. Five weeks later the stock price had risen to \$28.25, and if Sarnoff had

been free to sell, he would have had a capital gain of \$1,050,000. But then the stock began to fall, and by September when the six months' holding period expired, R.C.A. had dropped to \$23.50. Since the banks were unwilling to renew his personal loans in full, Sarnoff decided to sell some of his stock. To avoid depressing the falling market, he sold 75,000 shares off the market to private investors through Lazard Freres and Company for about \$21.50 a share. This gave him \$1,612,500, but to this he had to add most of his personal savings to pay off his loans and acquire the remaining 25,000 shares free and clear. Had Sarnoff been able to hold on to all his option stock, he would have had a potential capital gain of \$1,487,500 as of mid-October, 1954. As it turned out, he made a capital gain of \$281,250 on the 75,000 shares and had a potential gain of \$371,875 on his remaining 25,000 shares as of mid-October.

It was not considered likely that Congress would relieve executives of the necessity of taking at least six months' gamble on restricted options. For, by requiring this holding period, Congress intended to prevent insiders from manipulating a company's stock by frequent trading. However, two changes in the Revenue Act passed subsequently made it possible for companies to protect executives who have unexercised options against a decline in the market value of the company's stock.

Under the new rule on the "modification, extension, or renewal" of a restricted stock option, a company could lower the option price of a stock whose average market value over the preceding twelve months had been more than 20 per cent below the market price when the option was granted. Protection against a short-term decline in a stock's market value was provided by a new "variable stock-option" rule. This allowed an executive to exercise his option at a price that could be 85 per cent (or more) of any market

value of the stock during a specified six-months' period, and the option must be exercised in that period. Thus, if the market price of his company's stock dropped, an executive can wait and exercise his option at the lowest price during the six-months' period.

Companies whose stocks were either closely held, not traded frequently, or not listed on securities exchanges have found restricted options more difficult to employ. For some years one problem was the requirement that restricted stock options be granted only to holders of less than 10 per cent of a company's stock. This irked owner managers who naturally wanted options themselves, and who argued that if they offered stock options to other managers in their companies they might lose voting control. The 1954 Revenue Act remedied this by permitting the grant of five-year stock options to holders of more than 10 per cent of a company's voting stock on condition that they pay at least 110 per cent of the fair market value for their option stock. But Congress has so far done nothing to solve the chief option problem facing thousands of small and closely held companies. This is the difficulty of fixing a "fair market value" for their stock. A company offering the executives restricted options may set an option price at what it estimates to be 85 per cent of the stock's market value. But the Treasury may claim that the real market value is much higher than the company's estimate, and that the option price is therefore less than 85 per cent. Such option would not qualify as "restricted" and all the profits accrued when the option was exercised would be taxed as ordinary income. This would be so, at least, unless the company would convince the Treasury or the courts that the option was indeed "proprietary".

The only alternative to proving that a nonrestricted option is proprietary is for a company to admit that the option is designed to provide

compensation. For an executive to get capital-gains treatment on this kind of option, a different concept was adopted, namely that the option itself is considered to have value. This value is the compensation intended. If the executive is willing to pay income taxes on this value for the year the option is granted, he may be able to secure capital gains treatment on all profits realized on his option.

The efforts of corporations to secure capital-gains benefits for executives by granting them options are, of course, quite legitimate. But do much emphasis has been placed on the tax-avoidance aspects of options that it has tended to obscure the basic purpose of granting options, which is to give executives an incentive to stay with a company and help improve its earnings.

Some companies, such as Corn Products Refining, use stock options as a form of deferred compensation to ease the economic problems of retirement. Other companies, such as Moore-McCormack Lines, prefer to award options to younger men who are expected to boost earnings for many years. In still other companies, options are used as a short-term incentive for key executives. Yale and Towne Manufacturing Company, for example, adopted a five-year option plan in 1950, which provided that executives who received the options could not exercise them for at least three years. By this restriction President Gilbert W. Chapman aimed to hold together for at least three years the new executive team he had set up.

Effectiveness of Plans. The big test of the incentive-producing value of option plans, of course, will arrive when-and-if there is a prolonged decline in the stock market. In a booming bull market, stock options have brought many executives immense profits--on paper at least. They've enabled

hundreds of companies to hang on to key executives or to attract top talent from other companies.

When stock prices fall, many stock option plans, for the time being at least, become worthless to both companies and executives. In 1957, during a slump in stock market prices, some stock option plans fared about as follows:

Figure I

<u>COMPANY</u>	<u>OPTION PRICE</u>	<u>CURRENT MARKET</u>
Alaska Juneau Gold	\$ 3.25	\$ 2.50
Black and Decker	30.39	38.50
Cincinnati Gas and Electric	19.00	26.00
Columbian Carbon	45.00	35.00
Eastern Stainless Steel	39.90	30.00
Emerson Radio	6.25	4.25
Flintkote	42.00	36.00
Grayson-Robinson	3.75	5.37
Korvette	10.00	13.62
National Steel	62.50	59.00
Pennsylvania Railroad	21.00	16.12
Royal McBee	38.00	23.12
Sante Fe Railroad	28.50	19.62
Scott Paper	77.00	54.37
Shell Oil	81.14	70.50

Such a situation brought forth comments such as, "Sure, no one promised me I'd make money on the option, but it was held out as an employment attraction and now it's a mirage"; "I've got an option you can have right now".

A faltering stock market has made many an executive's employment contract far less attractive than when he signed it.

Company reactions to executives' comments varied from serious concern to amazement that their executives may be disgruntled because their options are worthless at present. One company president snapped, "Why should our people be upset? After all, it's difficult for them to lose on options, they don't have to exercise them, you know". Another said, "If you are after

a quick profit on a stock option plan, you have no business asking your stockholders to approve it".<sup>18</sup>

If the stock market should slump drastically, restricted option plans at least could be "modified" to give some executives a new start on their "free-ride" at a lower option price. This, however, would not protect those who had already exercised their options, and if many of them chose to cash in their profits before the company's stocks fell below the option price, they could scarcely be blamed. But such profit taking would obviously not support the theory that such options increase the executive's sense of ownership.

The incentive value of stock options, of course, cannot be accurately measured. For one thing, the movement of any company's stock price is affected by many factors over which management has little or no control. Wars, depression, inflation, as well as many other more moderate economic and physical factors may well cause changes in a company's common stock market value far beyond what management may control. Moreover, an executive may become so absorbed in fluctuating personal paper profits that he neglects his daily chores. Mr. Sarnoff, of Radio Corporation of America, referred to earlier might have been an example of this possibility. It would certainly appear that Mr. Sarnoff was faced with matters of a most pressing nature and size.

Other incentive systems, like bonuses tied to performance, may seem better to some companies. Restricted stock option plans often are a sore point with some company stockholders. Their complaints include: (1) Stockholders generally aren't eligible to buy the stock at a lower-than-market

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<sup>18</sup> "Ailing Options," The Wall Street Journal, October 21, 1957.



price, (2) company officers already are getting enough money, (3) the granting of options increases the amount of common stock outstanding, thus reduces earnings per share, and (4) if corporate officers have any faith in their own company, they will invest in its stock via the open market.

Difficulties of Plans. Despite the profit potential in many option plans, they often operate under many difficulties.

How can the option holder afford to purchase the securities offered to him? A right to buy stock may make an attractive incentive until the time comes to find the cash to pay for it. In the case of many current stock options, inadequate attention has been given to this problem of financing; as a result, the potential benefits to both management and the stockholders have been largely lost.<sup>19</sup>

Much criticism is directed not against the principle of the stock option plan, but against the unplanned type of option which, of necessity, will require the executive to sell a substantial block of stock in order to pay for a relatively few shares. This self-financing type of option is expensive to the company. Also, it may be loaded with potentially serious questions.

Here are a few of the difficulties: (1) Rapid shrinkage—the wasteful nature of the self-financing option is evident when we consider how many shares must be sold to finance the purchase of the remainder. The exact number will vary with the percentage increase of the market over the option price but, under any realistic assumption, the percentage sold will have to be substantial.

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<sup>19</sup> Harvard Business Review, March-April, 1957, p. 137.

Figure II

SELF-FINANCING OF A 1000-SHARE STOCK OPTION AT \$50 PER SHARE

<u>Appreciated Market Price Per Share</u>	<u>Percentage Increase in Price</u>	<u>Percentage of Stock That Must Be Sold</u>	<u>Number of Shares That Must Be Sold</u>	<u>Number of Shares That Can Be Retained</u>
\$ 62.50	25%	84.1%	841	159
75.00	50	72.7	727	273
87.50	75	64.0	640	360
100.00	100	57.1	571	429
116.50	133	50.0	500	500
250.00	400	25.0	250	750

Source: Harvard Business Review, March-April, 1957, p. 137

Dilution of Equity. The issuance of so many shares solely to enable the executive to finance his option may also be wasteful from the stockholder point of view. If the option stock is authorized but previously unissued and the executive must sell part of his option shares in order to acquire and retain the remainder, a dilution of equity will take place which hurts the executive as well as other shareholders. For instance:

Assume an option plan involves 5% of the company's outstanding shares at the time the plan is adopted. Assume further that 75% of the option shares must be sold to finance retention of the balance. Upon these assumptions,  $3\frac{3}{8}\%$  of the total stock outstanding after exercise of the option will have been issued and outstanding in the hands of the public at large solely to permit executives to retain an interest of only 1.25% in the company.

Cost to the Company. As distinguished from dilution of stockholders' equity, there will be a cost factor to the company in the case of both unissued and treasury stock. This cost can be considered the spread between the option price and market price of the option shares at the time of exercise of the option, since the company, in the absence of underwriting

costs, brokerage, or other factors, would ordinarily be able to sell the option shares for their market value. The cost factor is sometimes referred to as dilution. Thus, the Thiokol Chemical Corporation, in proposing an officers' and employees' stock option plan, stated:

"Management is mindful of the fact . . . because of the very nature of an option, at any time when the options might be expected to be exercised, the Corporation probably would be able to sell the shares subject to option for higher prices than the option prices and the sale of such stock at the lower option prices will have the effect of diluting the position of existing stockholders".<sup>20</sup>

Stockholders Objections to Plans. While the restricted stock options are understandably popular with executives who have received them, support for options is clearly not unanimous. A majority of the companies with listed securities on the New York Stock Exchange have not yet adopted such plans. Although few top executives in these companies are prepared to criticise stock options (management obviously doesn't want to denounce a plan it may one day decide to use—to attract a new president, for example), there is a general awareness in management of the case that can be made against preferential tax treatment for executives. In a 1950 speech to the American Bar Association, for instance, Dean Ervin N. Griswold of the Harvard Law School asked the central question: "Is there really any decent justification for the handouts which are reportedly about to be given to a special few taxpayers?" It is still a difficult question to answer. For it raises many issues on which even top managements are not unanimous.

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<sup>20</sup> Harvard Business Review, March-April, 1957, p. 138.

Are stock options really needed to attract new managers or to keep valuable key men from leaving? And are such options, which are generally limited to top executives, good for company's employees, public and stockholder relations?

Most specifically, do stock options really accomplish what many managements expect them to; i.e., do they increase an executive's incentive to improve company earnings by giving him "a stake in the business"?

Negative answers to all these questions have not been lacking. The sharpest critics of option plans have been minority stockholders who have generally attacked such plans on three counts: first, that granting options to buy at bargain prices dilutes the equity of other stockholders; second, that high-priced executives should not need an extra incentive to do their best for the company; and third, that options do not induce a "sense of ownership" in an executive unless there is some assurance that he will continue to hold a substantial part of his option shares.

Many managements, as already noted, have concluded that stock options are not suited to their companies. Some of the best managed companies, such as General Motors, have decided to continue to rely on the incentive of a substantial bonus (in G-M case, usually partly in stock) that can be tied much more directly to an executive's year-by-year performance. In other companies, pensions and deferred-profit sharing plans are used to stimulate managers. One of the biggest disadvantages of a stock option plan was cited by President Joseph A. Crazier of American Radiator and Standard Sanitary Corporation: "In a staid company like ours whose stock is not rising fast, an executive probably could make enough on his option to provide any real incentive, and if the stock drops, his morale will probably go down too".

Advantages of Plans. Yet, stock options have some real advantages for the corporation as well as the salaried executive. Owing to the capital-gains treatment accorded profits on restricted stock options, the granting of such options may cost the company much less than the granting of a salary increase large enough to net the executive as much as the profit on his option. Also, a general offer of stock options, in fact, often is the only way a company can acquire--or retain--the services of a top notch manager.

It appears to be true that the chance to acquire an estate through stock options undoubtedly produces some increase in an executive's desire to stay with the company and keep it profitable.

It appears from available information that stock options for officers and key employees continue to be a major device used by many companies to obtain or retain outstanding executives, in spite of what appear to be valid objections to certain features of many plans that have been put into effect.

Review of General Electric Company Plan. In its 1956 annual report, General Electric Company includes the following comment relative to its stock option plan.

"A total of \$6,814,341 was received in 1956 from the sale of 267,668 shares of previously unissued stock to holders of restricted stock options under the Company's Stock Option Plan. Of this total, \$1,338,340 represented the \$5 par value of the shares sold, and was added to the Common Stock Account. The balance of \$5,476,001 was added to Investment in Excess of Par Value of Common Stock.

The Stock Option Plan, approved by the holders of 97.8% of the shares voted at the 1953 Annual Meeting, provides for the granting of restricted stock options to key employees. The option price is market value on the date of grant, so there is no benefit to the option holder unless the market

price of the stock increases, which benefits all share owners. This acts as incentive for the employee to use his best efforts on behalf of the Company. As inducement to remain in the service of the Company, options may not be exercised immediately, but only in annual installments (over a period generally of nine to ten years) which become exercisable as the individual remains in the employ of the Company.

At the beginning of 1956, General Electric Company had a total of 3,258,195 shares of common stock subject to outstanding options. No additional restricted stock options for purchase of the Company's common stock were granted in 1956; 267,668 shares were purchased, as noted in the following summary; 76,771 shares were deducted from original grants in 1956 because of deaths, retirements and withdrawals; leaving outstanding options for 2,913,756 shares at the end of 1956. These outstanding options were held by 917 individuals. In submitting the Plan to share owners, it was estimated that between 700 and 1200 key employees would eventually participate in the Plan. Of 4,200,000 shares which the share owners authorized for use under the Plan, 680,364 were unallotted at the close of 1956.

A summary of 1956 transactions is shown below:

<u>Option Price</u>	<u>Year of Grant</u>	<u>Net Original Grants</u>	<u>Installments Not Yet Exercisable</u>	<u>Exercisable Installments As Yet Unpurchased</u>	<u>Shares Purchased in 1956</u>
\$23 3/4	1953	1,423,363	939,146	76,524	176,312
24 1/6	1953	788,742	532,806	80,156	71,753
45	1954	608,698	466,267	121,727	17,900
52 1/4	1955	698,833	618,716	78,414	1,703
		<u>3,519,636</u>	<u>2,556,935</u>	<u>356,821</u>	<u>267,668</u>

In order to combat and doubtless overcome the possible stockholder cry of dilution of capital interest, General Electric grants options to key employees at the current market on the date of grant, so that there is no benefit to the option holder unless the market price of the stock increases,

which benefits all share owners.

To overcome the objection that in some ways in many cases restricted stock option plans do not actually serve as incentives to management, in addition to the fact that, unless the market value of the stock increases above the value at the time of the option grant, there is no profit, General Electric induces holders of such options to remain in the service of the Company by not permitting the options to be exercised immediately but only in annual installments over a period of nine or ten years. It appears that General Electric's plan must result in more incentive to stay than many plans under which the option may be exercised in full in a relatively short time. In these cases, a key employee, having exercised his option in full and having a substantial capital gain at hand, might easily be attracted to another company, perhaps under a comparable plan.

According to information published by the New York Stock Exchange, General Electric's stock option plan provides for the stock obtained from such options to be paid for in full in one payment. This requirement of a single cash payment in full leaves quite a problem at least for some of the option holders. General Electric's annual report states that 4,200,000 shares had been set aside for their plan and that it was estimated that between 700 and 1200 key employees would eventually participate. It also states that at the end of 1956 there were outstanding options for 2,913,756 shares and that these options were held by 917 individuals. Assuming that a middle figure of 950 key employees eventually participate in the 4,200,000 set aside for the plan, the average participant will be given an option or options for approximately 4,421 shares. On the basis of the last option price of \$52 1/4, the total cost per participant will be approximately \$230,997. It is reasonable to assume that certain high-ranking key employees have or will receive

more shares and, of course, some less. With today's high income taxes, the outlook for a continuation of such high taxes, and the standard of living normally associated with such top key employees, the payment of \$230,997 is a major obstacle. A similar computation of the average number of shares per participant at the end of 1956 results in a cost per key employee of approximately \$197,000. This amount, too, is a formidable obstacle.

It might be said that the financing of a key employee's stock is his own personal problem and does not in any way concern General Electric. It may be said that every buyer of stock bears this same responsibility and that General Electric's key employees are and perhaps should be like the others; that if he can't afford to buy the stock, he shouldn't buy it.

There may be a very substantial difference between a General Electric key employee option holder and the average stock buyer. If Mr. Blank, a General Electric key employee option holder has exercisable option rights for 4421 shares, which were granted to him when the price of the stock was \$52 1/4, and the current market price of the stock was \$75, he would perhaps be in the position of not being able to afford to buy the stock and at the same time of not being able to neglect to realize a capital gain of \$100,578, particularly if he felt that \$75 was a good price for the stock. Even though he is a key employee of a large company with a very substantial salary, Mr. Blank might never undertake to buy stock in one company costing \$230,997.

Of the various criticisms of restricted stock option plans, General Electric's plan seems to be vulnerable to that of not providing means for paying for the stock. In the absence of reasonable provisions for making payment for the stock under option, unless Mr. Blank had a larger personal estate, especially as to available cash, than most key employees have, his



only means of financing his purchase would be to dispose of a portion of his stock in order to pay for the part he could hold.

As far as the 1956 annual report disclosed General Electric does not require a key employee to retain his stock but rather seeks to induce such employee to remain in the service of the company but making the options exercisable only in annual installments over a period generally of nine or ten years so long as the individual remains in the employ of the Company.

Recent Reports on Restricted Stock Option Plans. "Under the Restricted Stock Option Plan for key employees of the Company and its subsidiaries, approved by the Stockholders at the 1957 Annual Meeting, on January 1, 1962, there were 376,200 shares issuable under outstanding options and 282,187 unoptioned shares available for the granting of options. During 1962, options for a total of 11,200 shares expired and, therefore, on December 31, 1962, there were 365,000 shares issuable under outstanding options and 293,387 unoptioned shares available for the granting of options. No options were either granted or exercised during 1962 and there was no change in the exercise price; viz., \$21.00 per share under all options except one for 1,000 shares as to which the exercise price was \$19.00 per share."<sup>21</sup>

The fact that no options were exercised during 1962 is not surprising since the market price of the stock stayed below the option price of \$19.00 throughout the entire year.

"The incentive stock option plan for executives, adopted at the 1959 annual shareholders' meeting provides that up to 3,000,000 shares of Jersey's capital stock may be optioned at prices not less than 100 per cent of market

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<sup>21</sup> The Pennsylvania Railroad Company Annual Report for the year ended December 31, 1962, p. 32.

value on the date of grant. Changes that occurred during the year in the outstanding options, which may be exercised after two years of continuous employment following the date of grant, are summarized in the accompanying table.

Option Changes During 1962

Outstanding, December 31, 1961	2,222,983 shares
Granted (to 625 executives at an average of \$56.79 per share)	688,900 shares
Less: Exercised	(362,175) shares
Expired or canceled	(16,309) shares
Outstanding, December 31, 1962	<u>2,533,399 shares</u> <sup>22</sup>

Figures are not yet available to show comparable information for 1963, but with the market price at the close of business on March 11, 1964, of \$81 3/4, it would be reasonable to forecast considerable activity under this option plan.

"Corporations' stock option plans for their executives are expected to be the object of more than usual attention at annual meetings this spring. The plans, always controversial, have become more so recently. Some stockholders probably will have many questions to ask. The heightened interest has developed from the \$3,891,811 benefit obtained last year by seven top Chrysler Corporation executives through options. The size of the Chrysler executives' profits was attacked in Congress by Senator Albert Gore, Democrat of Tennessee. . . . Senator Gore said he was not charging that the Chrysler officials violated any law or that their company is alone in the practice, although he said he believes Chrysler took unusual advantage of it.

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<sup>22</sup> Standard Oil Company (New Jersey) 1962 Annual Report, p. 25.

'This stock option privilege is a tax abuse which is growing,' he said. 'It is detrimental to the interests of the stockholders of the company involved and it is unfair to all other taxpayers.'

George H. Love, Chrysler chairman defended the option plan. He said it was an incentive to the company's management and "helped the company write one of the finest comeback stories in the annals of American business." "Two years ago Chrysler was floundering," he said. "The search for top management candidates outside the company was fruitless--no one wanted the job. We finally decided to entrust the fortunes of the corporation to the younger but experienced and aggressive men who were running it on an interim basis. By using stock incentives already approved by shareholders and thus holding out the opportunity to share in the company's improvement, good men both in and out of the corporation were persuaded to tackle this really formidable task."

It would appear that Chrysler stockholders, if they complain of these executives' benefits, should at least have mixed emotions. Adjusting for stock splits since this new management took control of Chrysler's destiny, the corporation's common stock has increased from a market value of \$15.00 per share to a recent high of \$49.00. Stockholders generally have shared the same benefits as have those few top-management option holders.

Assuming that these management option holders each had a taxable income of \$150,000 for 1963, exclusive of the gains from these options, the addition of \$555,967 (\$3,891,811 divided by 7) regular income would have resulted in an additional Federal income tax of approximately 90 per cent of the \$555,967, or \$500,370. By reason of the long-term capital gain benefit under the restricted stock options, the \$555,967 bonus could not result in an additional

Federal income tax greater than 25% of the bonus, or \$138,992. The saving of \$361,378 per man is obviously substantial.

While the income tax savings to the option holders is quite substantial, any stockholder who held stock during this period enjoyed tax benefits at least equal to the benefits of the option holders.

## CHAPTER VI

Although restricted stock options have always been highly controversial and under more or less constant attack from several sides, the fact that Congress, the law, the courts, and most stockholders have generally approved would seem justification enough. But the most persuasive vindication for granting management the chance to gain more at less risk than the ordinary investor is that this should make executives much more conscious of their responsibility to stockholders, and perhaps produce larger profits for all.

However the legislation first passed in 1950, which conferred Federal income tax benefits on restricted stock options has only recently been materially changed by the Revenue Act of 1964, which was enacted February 26, 1964.

Some of the new rules are as follows:

1. For full tax benefit, the stock must be held for three years after exercise. (Formerly the holding period was six months after exercise and two years after grant.)
2. Grantee of option must be an employee of the granting corporation, its parent or subsidiary, continuously from grant to three months prior to exercise. (Formerly a break in employment did not disqualify a restricted option if an employee were such at the time of grant and within three months of exercise.)
3. There must be a plan running for not more than ten years specifying the total option shares and the employees or classes of employees to receive options. Stockholders must approve the plan within twelve months before or after its adoption. (There was no such provision formerly.)

4. Options may run for not more than five years after grant. (Formerly, the period was ten years.)
5. At the time of grant, the employee may not own, directly or indirectly, more than 5% of the stock (in voting power or value). If equity capital is \$1,000,000 or less, the 5% is increased to 10%. (Formerly, the restriction was 10% of voting power regardless of capital but larger stockholders could qualify, subject to limiting conditions.)
6. For full tax benefit, the option price must not be less than 100% of market price of stock at the time of grant. A lesser per cent does not necessarily disqualify the option, but results in an increased tax. (Formerly, option plans were disqualified if the option price was less than 85%.)
7. Variable options are not allowed. (They were allowed, formerly.)
8. To prevent a downward readjustment of the price, a qualified option must provide that it is not to be exercised until any prior qualified or restricted options are fully exercised or lapsed, with certain exceptions. (Formerly, additional restricted stock options could be granted and downward price adjustment was allowed in some cases.)

Evidently the number and the size of these option plans must have been of considerable magnitude to have warranted the time and attention recently given by Congress in the New Federal Income Tax Law (The Revenue Act of 1964) and it will be interesting to see how the corporations with stock option plans adjust to the new restrictions and how soon they find a way to accomplish the end result that was heretofore permissible, one that they obviously considered very desirable and beneficial.

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